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Conflict and Control in the World Economy:

Contemporary Economic Realism and Neo-Mercantilism

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2 The Liberal Approach to Economics and the Global Political Economy

The liberal approach to economics has a long and highly influential history. It is a perspective upon economic life that has influenced the policies, and practices, of governments and attracted the intense interest of many of substantial intellectual powers. A phenomenon of such power and influence clearly demands the closest attention and scrutiny.

The sceptic might be suspicious of any system of ideas that so bedazzles some minds and that seems to offer such a clear and rigorous theory of a major part of the human condition. It will be one of the purposes of this chapter to indicate that such scepticism might well be warranted. While the wholesale abandonment of insights generated by liberal economics will certainly not be advocated, it will be argued that analysis should be developed within an alternative framework: a framework into which liberal insights may be incorporated selectively and with due caution.

In any critical examination of a school of thought or a given approach to analysis there is the inevitable question of the reality of that which is being discussed. The difficulty, here, is the boundary that is to be drawn around any approach, and its adherents. In the case of economic analysis it is clear that there are those whose views are difficult to classify in any simple and clear manner. The current positions of many whose origins lie within liberal theory have developed in such a way as to raise serious doubts about their continuing compatibility with the central tenets of that approach. Many of those who might be entitled post-Keynsians, ultra-Keynsians, or, in the North American context, 'institutionalists' have wandered far from the liberal faith in the benign

effects of the 'hidden hand' that supposedly operates within an unconstrained *laissez-faire* economic system.

The ability to differentiate schools of thought by highlighting their differences also assists with the accusation of unfair attributions of belief, or view, to those who are grouped together under a common title. Here, again, the simplest defence of any system of classification may be to establish the marked contrasts of basic outlook that exist between those who have been placed in any one category and those in contrasting categories. On such grounds, liberals are clearly differentiable from Economic Realists or socialists, while neo-classicists may be further distinguished by their unique confidence in general equilibrium analysis and the role of impersonal processes.

A clear view of, and critical approach towards, the liberal approach to economics must, therefore, be based upon some awareness of its central arguments and basic propositions. Only when these have been examined can systematic criticism be undertaken. What follows, then, is an outline of an inevitably simplified model of the liberal position, and a critical re-examination of some of its basic assumptions and arguments.

THE LIBERAL PURPOSE

The liberal perspective shares one central difficulty with many other approaches to economic life: a problematical fusion of positive analysis with normatively based prescription.[1] This intimate blend of statements about the 'is' and the 'ought' was central to the work of the early, classical liberal economists. One of Adam Smith's essential purposes was to criticize mercantilist practices while advocating the adoption of liberal economic policies.

It is quite clear that criticism of alternative approaches to economic analysis and the conduct of economic policy has remained central to the liberal enterprise throughout the long course of its evolution. Mercantilism, and its modern neo-mercantilist variant, and socialism are attacked vigorously for their interference with the free operation of a

competitive market, and the damage to economic efficiency and consumer satisfaction that supposedly results. In the case of socialism, additional criticism is directed against its opposition to self-interested behaviour, acquisitive purpose and entrepreneurial spirit. Some confusion is common on this last point, however, for there is no necessary connection between an extremely efficient competitive market system and private property (or, more particularly, the private ownership of the means of production and/or noticeable inequalities in the distribution of wealth and income). This confusion is a product of the wider set of values entertained by many liberal economists and illustrates one of the dangers that follow from the unavoidable role of value-based theory in the development of any observation and analysis.

The fusion of positive and prescriptive analysis is not, however, peculiar to those whose explicit intention is to offer policy recommendations or to promote the realization of personal values through changes in economic policies and practices. Some increasingly influential theories about the inevitable connection between personal values, established ideas and empirical study indicate that it is a delusion to believe that strictly 'objective' analysis and, therefore purely positive theory, is possible.[2]

The complexities of the relationship between personal values, established views and empirical analysis reflect a number of issues. Such issues include the role of personal interests and values, the necessity for theory before embarking upon orderly empirical investigation and, finally, the possible need to incorporate reference to non-observable factors or forces within effective analysis.

It is clear that interests, of one kind or another, direct the initial attention of investigators. It is rare, even within the somewhat rarefied atmosphere of academia, for analysts to devote time and energy to studying matters that they find uninteresting or that they believe to be quite insignificant.

All aspects of human affairs, including economic activity, are areas of considerable, if not overwhelming, complexity. This complexity can be brought under some sort of intellectual control only if it can be simplified from the outset and if means are established for selecting the most salient features

for further attention. Unfortunately, the bases of simplication and selection involve the application of ideas about how reality works, and the features that are most significant. Such selectivity and simplification necessarily precedes systematic empirical investigation and amounts to the application of a form of theory. Moreover, such prior theory generally reflects value judgements and orientations: significance is established by views on how reality affects cherished values or how reality might be better moulded so as to ensure their satisfaction. Theory thus directs empirical investigation. Empirical investigation may prompt the subsequent modification, or even transformation, of theory.[3] However, a 'chicken and egg' cycle characterizes the study of human affairs, into which initial entry is facilitated by the individual's earlier enculturalization and formal education.

Many analyses of complex features of human life, finally, employ references to factors and forces which are not immediately observable but which have to be inferred from the occurrence of their supposed effects within observable reality. Most of the references to systems and structures that are made within the social sciences are of such non-observables. Actual experience is always that of actors who exist within, and whose behaviour reflects the influence of, such systems and structures, rather than of the system or structure itself. However, an account of the activities of the actors who have been observed may be fundamentally deficient unless reference is made to the influential non-observables.[4] The significance of non-observables, then, is that they have a complex relationship with apparent reality, are essentially theoretical and are conceived through a complex process of thought and observation.

The liberal analysis of economic life, in whatever form, cannot, therefore, achieve the objectivity which some proponents have claimed and which has been proclaimed in far too many textbooks of economic theory and analysis.[5] The apparent plausibility of many basic liberal economic ideas does not secure them against the difficulties that have been discussed above. Such difficulties do not, however, affect liberal theory any more or less then the contending approaches.

The values that are inherent in the liberal perspective need not be disguised or denied. They demand careful consideration and are open to acceptance or rejection according to the personal inclinations of each student of human affairs. Adam Smith was more than a mere apologist for emergent capitalism, he was also an unashamed, and wholly justified, advocate of fundamental principles of individual liberty.

THE LIBERAL ARGUMENT

The liberal argument can best be understood in terms of three primary elements. First, it offers the identification of characteristics of human economic activity that are held to be common to all people in all places and at all times. Second, it develops an analysis of the implications that such universals of economic behaviour have under a variety of conditions. Third, but by no means least, it specifies the highly desirable consequences, for the population of any community (national or global), of allowing unfettered free-market principles to prevail.

Throughout the analysis, the liberal model rests upon a number of initial assumptions that necessarily, and explicitly, limit its correspondence with reality. The defence of such limiting initial assumptions is that they provide the analysis with its manageability and precision, while still allowing it to generate fruitful insights into economic reality. However, the newcomer should always recall that the initial assumptions of the liberal approach do constitute a substantial, and potentially very serious, simplification of reality.

Much of the liberal argument can be stated in mathematical terms or, as is common in economics textbooks, in graphical form. For those who are conversant, and happy, with such techniques this practice can do much to assist comprehension. However, there are many for whom such procedures are baffling and something of a deterrent. Since this account is intended for readers who may well fall into the latter category it will concentrate upon verbal exposition.

The liberal arguement starts with a vision of an economic society of rational actors. Such actors are rational in that they

seek to maximize the benefits obtained from those resources with which they are endowed. Within a complex market economy, the exchange of goods and services is usually facilitated by the use of money. As consumers, rational actors use their income and wealth to purchase the combination of goods and services that provides them with the highest possible level of overall satisfaction of needs and wants.

As producers, rational individuals also seek to use their skills, energies and equipment to produce those goods or services which can be sold for the highest return (or other payments-in-kind) in the market-place: the profits and wages thus accruing being ultimately used to purchase goods and services (or additional equipment with which to enhance productive capabilities, and hence income-earning capacity). Rational consumers will, in general, purchase more of any good or service if its price is lowered and vice versa. Rational producers will, in contrast, generally supply more at a higher price and less at a lower price (as profits are, respectively, raised or lowered).

The magical feature of an unfettered free, competitive market, however, is the way in which it encourages patterns and supply to move into balance with one another. If consumers do not wish to buy the volume of a good—say apples—that has been supplied to the market at the price initially asked, then stocks will remain unsold. If sellers do not wish to make an absolute loss on unsold stocks they will reduce prices to encourage additional sales. Rational consumers will be encouraged to buy more apples because the lower price now makes them more attractive than some of the other goods and services that were previously purchased. Prices will continue to be lowered until a price is reached at which stocks are sold without the formation of queues of unsatisfied potential customers.

In the example under consideration, and under suitable technical conditions, the market gradually moves towards stability. Rational producers will not continue to supply the original volume of apples. They will switch some of their resources to the production of alternative goods, the market prospects of which seem to be more promising. As the level

of supply gradually falls, the price will rise once again, for it will be less and less necessary to cut prices to clear surplus stocks. Eventually, the level of supply of apples to the market will (uncontrollable influences aside) be such, and at such a price, as to ensure that all stocks are sold, that there are no queues of unsatisfied customers and that no producer is still supplying apples at a level of profit lower than obtainable through alternative uses of productive resources.

This model of the market for any good or service is the key element in liberal economic theory. Its range is considerable, for an identical analysis can be applied to such apparently diverse phenomena as the demand and supply of labour within an economy, the demand and supply of savings for investment, and the exchange rates of those national currencies that are traded on international money markets.

The real economy constitutes a simultaneous market for the entire range of goods and services being produced and purchased. Adjustments in the market for one item involve adjustments elsewhere, as consumers are encouraged by changing relative prices to adjust the relative balance of their purchases and as producers are encouraged by changing profit levels to redirect their productive resources. Eventually the whole market will be balanced in a condition of *general equilibrium*, albeit through an extremely complex set of evolving individual consumption and production decisions. Such a condition of general equilibrium marks the most efficient—the optimal—deployment of the community's productive resources, for it provides the highest overall level of satisfaction of those popular demands that have been expressed through market demand; and the satisfaction of the people's economic wishes and wants is the exclusive definition of efficiency within the liberal perspective. This notion of general equilibrium now occupies a central place in modern liberal economic theory and is an essential article of faith of neo-classicists.[6]

The extension of the liberal argument to the entire global community involves no serious departure from the account of the achievement of general equilibrium within the domestic market provided above; merely its amplification in a few important areas.[7] The first problem with which international

economic relations confronts the liberal approach is the need to explain why communities should have any economic relationships with one another. The initial, and seemingly quite sensible, response of the liberal economic theory was to argue that societies would trade with one another to secure those commodities, goods and services which could not be produced or obtained domestically. Societies would then export some of the goods and services that they were able to produce at home so as to pay for those that they had to import. The principle of this early explanation of international trade was that of *Absolute Advantage*. Unfortunately, the principle of Absolute Advantage fails to account for the complexity of international trade that is actually encountered. The real world reveals patterns of trade in which societies import goods and services that they are quite capable of producing domestically. Indeed, it is the case that some societies both import and export certain goods and services; as does the United Kingdom in the case of motor vehicles. It is, moreover, quite possible for two or more societies to import and export similar goods to one another simultaneously.

The much vaunted principle of *Comparative Advantage*, which will be outlined below, has been advanced to explain the apparent peculiarity of a situation in which societies import those goods and services that they could well produce domestically. Explanations of the more complex patterns of trade in which similar goods and services are traded simultaneously in both directions refer to such features of modern production as brand names, advertising and the general attempt to establish product differentiation, albeit largely illusory. This latter explanation is, however, somewhat insecure and controversial, for the trade pattern in question may be transitional rather than persisting: a symptom of the gradual shift of relative competitiveness between societies rather than a strange, but durable, condition. The discussion will return to this point later in the volume.

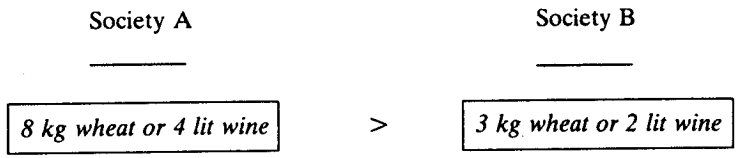
Comparative Advantage

The principle of Comparative Advantage is central to the liberal explanation of, and justification for, international trade. It is of sufficient importance to the liberal approach, and of such general interest, as to warrant a brief discussion. The power and subtlety of this principle is that it demonstrates that even where one society is more efficient at producing the entire range of relevant goods and services than any other, there may still be a sound basis for mutually advantageous specialization of production and subsequent trade between the two societies.

The principle of Comparative Advantage can best be explained through the conventional technique of adopting a highly simplified model of reality. The most appropriate model here is that of a world in which there are two societies which initially produce the same two products and do not yet engage in trade with one another. The life of the people of the two societies is simple yet happy. The climate and natural conditions are such as to allow them to secure shelter and produce clothing with relative ease on an individual, or family, basis. All that has to be, and is, produced collectively is wheat and wine.

The first of these two societies—society *A*—is actually more productive and efficient than the other—society *B*. For every day a worker devotes to production within society *A*, eight kilograms of wheat *or* four litres of wine are produced. In contrast, in society *B* one day of effort by one worker produces only three kilograms of wheat or two litres of wine. Since society *A* is clearly more efficient (in terms of output per man day of effort) at producing everything than is society *B*, there would not seem to be a sensible basis for specialization of production and the development of trade. However, the principle of Comparative Advantage belies first appearances in such cases and highlights the very real advantages that could accrue from such a development. The Figures 1.1 and 1.2 are intended to illustrate this possibility.

Figure 1.1 illustrates the overall relationship between productive efficiency in society *A* and society *B*. Figure 1.2, by reducing the figures for society *A* and society *B* to a common base (one litre of wine), allows a more direct comparison of the relative efficiency with which wheat and wine are produced within society *A* and the relative efficiency with which they are produced within society *B*: the compari-



Note: > indicates the greater efficiency and productivity of society A over society B (in terms of output per man day worked)

Figure 1.1: The overall levels of productive efficiency in societies A and B.

Note: The values have been obtained by reducing the figures for productivity of society A and society B to the common based of one litre of wine: that is by dividing society A's figures through by four and society B's figures by two. This, while appearing arbitrary, is legitimate, here, because it is no longer the overall levels of efficiency of the two societies that are now of interest.

Figure 1.2 The comparison of the relative efficiencies of production within society A and society B.

son in which we are interested when considering Comparative Advantage.

Figure 1.2 thus makes it clear that, irrespective of the levels of overall efficiency, society *A* has a particular advantage in the production of wheat. Before trade develops with society *B*, society *A* has, in a sense, to give up two kilograms of wheat whenever one person's labour is devoted to the production of one litre of wine. If it became possible to obtain wine at a 'price' of less than two kilograms of wheat, from some other society, then it would clearly benefit society *A* to give up producing wine domestically, specialize in producing wheat and trade some of the additional wheat for the 'cheaper' foreign-produced wine. In the case illustrated in Figure 1.2 it is possible for such specialization and trade to develop. Society *B*, for its part, recognizes that if it is able to

obtain more than one and a half kilograms of wheat for one litre of wine through international trade then it would be advantageous to give up the domestic production of wheat, specialize in wine production and trade some of its additional wine for foreign-produced wheat.

The mutual advantage from specialization and trade, inherent in the example given in Figure 1.2, may best be demonstrated by the arbitary selection of a trade ratio of one and three quarters of a kilogram of wheat for one litre of wine. In the case of society *A*, for each litre of wine that is no longer produced domestically two kilograms of wheat can be produced. However, only one and three quarter kilograms of wheat have to be 'paid' for one litre of wine pruchased from society *B*: society *A* has thus profited by one quarter of a kilogram of wheat from this new pattern of specialized production and international trade. On its side, society *B* now finds that it has to give up only one and a half kilograms of domestically produced wheat for every additional litre of wine now produced, but is able to obtain one and three quarters of a kilogram of wheat when its wine is traded for wheat from society *A*. Society *B* has also profited by one quarter of a kilogram of wheat from the new pattern of production and trade.

For societies *A* and *B* taken together, then, there is mutual benefit and an increase in overall production when specialization and trade develop. The overall level of wine produced and consumed will remain as before specialization and trade. However, the volume of wheat produced and consumed will have increased, with the benefits of that increase being shared between the two societies. The level of benefit that each society enjoys will not necessarily be the same, however, for the exchange ratio of one and three quarter kilograms of wheat for one litre of wine is merely one possibility (albeit the fairest). Any exchange ratio would be possible within the range marked by the limits of two kilograms of wheat for one litre of wine and one and a half kilograms of wheat for one litre of wine.

The real world, of course, exhibits far more complex patterns of trade than that envisaged in this example. Moreover, the great bulk of such trade is facilitated by money

rather than direct barter. Simple exchange ratios are, therefore, rarely possible to identify. However, the distribution of the supposed benefits from specialization and trade is a matter of very real concern and controversy, as will be seen later in this discussion.

On a global scale the promptings of Comparative Advantage will, liberal theorists believe, provide the driving force for a general pattern of specialization and trade. Free-market mechanisms will bring about the matching of demand and supply for any given good or service and the system will eventually attain a condition of general equilibrium. At this point, the world's productive resources will be deployed in such a way as to ensure the maximum possible satisfaction of the wants and needs of the human population.

Modern liberal economic theory has not been confined to an explanation of international trade in terms of those patterns of factor endowment that underlie Comparative Advantage and, hence, competitiveness. There have been some further developments that are worthy of note. Heckscher and Ohlin's work on factor endowments has been extended, particularly by theoreticians like Paul Samuelson,[8] T. M. Rybczynski[9] and Harry Johnson,[10] to specify the equalization of the prices (or rewards accorded to) factors of production in different countries that will follow from free trade. This theoretical development, however, remains within the same methodological framework as the original theory of Comparative Advantage and has been the subject of considerable theoretical controversy, particularly with regard to possible variations of supply of factors of production, with changing 'prices', the unequal applicability of production technologies in different countries, and ambiguities in the definition of 'capital'.[11] The empirical evidence for factor price equalization has also been, at best, equivocal.[12]

A lesser refinement of the liberal theory of international trade concerns the opportunities it provides for the satisfaction of varied tastes and the attainment of economies of scale by producers that are highly specialized, or significantly differentiated from their competitors. The principle of Absolute Advantage has long identified the opportunities that international trade provides for the consumption of goods that cannot be produced domestically. This possibility can be extended to cover the consumption of those goods that it would be possible to produce domestically, but for which there might be an inadequate level of demand to justify that production (given the costs of small-scale production). The production of such a good in one country, but for an international market, might then permit production on a scale sufficient to secure sufficient economies to scale to render production 'economically efficient'.

The economies to scale permitted by an international market might not be to the advantage only of those who desired a good that would not otherwise be produced. Such economies might also permit the increased differentiation of products within an industrial sector as producers are able to secure sufficient levels of production, and attendant economies of scale, for more specialized versions of the good. The effect of such differentiation of products should be the greater satisfaction of the particular desires of a larger number of consumers. The clear possibility of such effects indicates that some international trade may well be highly desirable. The argument in this volume is not, therefore, against international trade itself, but about the extent of that trade and the conditions under which it might best take place.

Analytically, liberal theory life purports to identify the powerful mechanisms that underlie and direct economic life—mechanisms, moreover, which will ensure the greatest well-being of all if left to operate unhindered. A number of the processes highlighted by the liberal approach do, certainly, play an important role in many aspects of economic life. However, their centrality is rather more open to question. Moreover, many of the basic assumptions of liberal economic theory are unsound, and many of its purported conclusions are essentially insecure. To differentiate between the fanciful and the fruitful within liberal economic theory therefore requires a critical re-examination of its basic argument, and the suppositions upon which it rests.

CRITICISM OF THE LIBERAL APPROACH TO ECONOMIC LIFE

Liberal economic theory embraces a considerable range of difficulties and shortcomings. The approach rests upon a number of basic assumptions, which vary in their complexity rather than their theoretical importance. Many of these assumptions subject the approach to very serious limitations or, in a significant number of cases, are simply unsound. The procedure adopted here will be to subject a range of such assumptions to critical examination, in order of ascending complexity.

Rationality

Assumptions of rationality, in one guise or another, are central to many theories of economic, social and political behaviour. The liberal approach to economic life, too, is founded upon an assumption of rationality, but rationality defined in such a way as to create serious problems for the realism of the resulting theory.

The question with rationality is that of the range of possibilities to be included within, or excluded from, its purview. Range, here, affects the linked issues of the manageability of the analytical task that is being undertaken and the predictive power of the resultant theory.

If any, and all, purposes of human beings are to be accommodated it becomes possible, though not necessary, for any human action whatsoever to be deemed rational. Such a possibility is sometimes accepted, albeit briefly, in textbook outlines of liberal economic theory but it cannot long be tolerated for it traps the approach in endless tautology: rational behaviour is anything that the individual believes will best serve his, or her, purely personal desires; and actual behaviour, which is not clearly chaotic, is then rational because it reflects what each individual thought would best serve his, or her, personal desires. Such an approach to rationality would render liberal economic theory quite unable to make the kinds of judgements about behaviour to which it aspires.

A definition of rational action that accommodates any and all human purposes compounds the basic issue of the predictability of human behaviour. No theory of human activity can entirely escape the problem that perfect prediction of individual behaviour requires full knowledge of all the individual's desires, perceptions and understandings that are pertinent to the potential form of behaviour. However the wider the range of desires, relevant perceptions and understandings the more intractable are the problems of confident prediction. Moreover, the wider the range of the behavioural influences that are permitted, the wider is the range of variation in individual behaviour that will have to be accepted. Claims that individual differences disappear in the aggregate will thus become increasingly strained as the range of accepted influences widens.

Liberal economic theory substantially restricts the definition of rationality in its attempt to combat the problems of tautology and manageability to those human purposes that can be realized through economic exchanges: that is, explicit exchanges of given goods and services for other goods and services whether directly, or indirectly through the use of money. In practice, liberal analysis is also much aided by a pragmatic emphasis upon those economic exchanges that involve money. Money is not merely a medium through which exchanges take place and a store of wealth, but is also, and most significantly, a standard measure of value and quantitative measurement. The advance of quantitative studies of modern economic activity has been particularly aided by this rather convenient restriction upon the range of empirical interest and research.

It is important to acknowledge, at this stage of the discussion, that the explicit, and extreme, restriction of purview is wholly legitimate for any social science. The adoption of a clear, albeit narrow, set of initial assumptions is invaluable if an orderly approach to a complex and problematical realm of human activity is to be sustained. Indeed, much can be gained from the development of restrictive, arbitrary and highly formalized models of reality—heuristic models. The internal dynamics of these models can be subjected to detailed investigation and their analytical implications subsequently checked against reality. Such a technique is par-

ticularly valuable for exploring the full implications of assumptions which have been made but which might not, otherwise, be fully tested. Alternative visions of reality, or of the forces underlying apparent reality, can also be investigated through such models. The danger of such models and procedures, however, lies in the possible confusion of the model with reality: of trying to force a messy and intractable reality into conformity with an intellectually more satisfying vision.

In the case of liberal economic theory's treatment of rationality, the substantial restriction of those human purposes that can be accommodated is such as to cut the theory off from a major part of that reality which impinges upon, if not actually characterizes, the 'economic'. Worse, in the hands of committed acolytes, such a restrictive approach to 'rationality' soon transforms itself into an implicit illegitimization of all those human purposes that 'threaten' to interfere with the realization of economic rationality. An acknowledged simplification of reality has thus metamorphosed into a critique of reality: Frankenstein's monster, instead of being an extremely poor imitation of a human being, has become the mould for future generations!

In the contrary direction to that of an unduly restrictive conception of rationality, neo-classical 'supply-side' economists have now become enamoured of the concept of 'rational expectations'.[13] This 'catch-all' analytical convenience has served to rationalize many of the observed departures between real developments and the expectations generated by earlier formulations of neo-classical economic theory, including 'monetarism'.

Liberal economic theory's treatment of rationality has been discussed at some length and in some detail both because it is central to the liberal analysis and because its precise nature, and implications, will often be lost upon the unprepared reader. Some of the other assumptions of the liberal model of a well-functioning, competitive, free-market economy are equally basic, but unrealistic and even absurd.

Prominent amongst the assumptions that are central to the liberal economic model are many which, in Charles Kindleberger's trenchant terms, remain 'heroic and unrealistic'.[14] These include: perfect information; perfect competition, including the absence of monopolies, oligopolies, barriers to entry and the free movement of all mobile factors of production; a generally equal distribution of wealth and income; the reality of general equilibrium, whether manifest or underlying, and the attainability of relative stability within the empirical economy; and the absence of uncompensatable negative externalities, paradoxes of rationality and zero-sum features within the economic realm. It is to such assumptions that the discussion is now addressed.

Perfect Information

If the promises of the liberal economic model are to be fulfilled then actors must be equipped with perfect information. Rationality, in liberal economics, is not just a matter of trying one's best when making decisions; choices must be correct at all stages. Unless consumers and producers are fully aware of all the economic possibilities that are open to them, and of all the consequences of any course of economic activity that they may take, they will not be able to choose rationally. Consumers will fail to secure the highest possible level of satisfaction if inadequate information denies them the ability to determine their consumption patterns rationally. Consumers will also fail to maximize their satisfactions if they are prevented from developing an awareness of their 'real' needs and wants: a suppression of true 'consumer sovereignty'.[15]

Producers will fail to supply that range of goods and services that are most wanted by consumers if they, in turn, are unable to make rational decisions about the allocation of their productive resources. Liberal economic theory's promise, that a *laissez-faire* economic system will deliver the maximum level of consumer satisfaction and the optimal allocation of productive resources, is thus dependent upon the availability of perfect information to all those involved.

Perfect information may be a central requirement of the liberal economic model: it remains patently absurd, however, under all but the most exceptional of circumstances. In the modern, complex economy the range of potentially pertinent information that confronts the potential

consumer or producer is enormous. Moreover, the individual would probably find such a range of information intellectually unmanageable. Most actors for most of the time are, however, denied access to anything approaching comprehensive information. Information may be located at a distance or remain technically incomprehensible when obtainable. Much pertinent information is, and always has been, kept secret. Most significantly, the information that is often decisive in determining whether an economic choice ultimately proves 'rational' is information about future conditions. Unfortunately perfect information about the future is intrinsically unobtainable. Liberal economic theory is thus confronted by a fundamental problem, a point which will be taken up again later in the discussion.

Perfect Competition

Pefect competition is also essential to the liberal economic model. If prohibitive obstacles confront those who might be able to sell goods and services at the lowest possible cost then inefficient producers wil continue to operate in the marketplace. The higher prices charged by inefficient producers reduce the purchases that consumers can make of other goods and services and hence reduce their general level of satisfaction. Reduced purchases of these other goods and services will lead to a lower than optimal allocation of resources to their production. The excessive use of productive resources by inefficient producers is thus matched by the under-use of resources by producers of other goods and services and a net mis-allocation of productive resources is thus engendered (mis-allocation, that is, relative to the allocation of resources that would occur when all production was as efficient (and cheap) as possible).

Barriers to Entry

Such a mis-allocation of productive resources through inefficient production can be corrected, within a liberal world, only through the emergence of more competitive producers who use resources more efficiently and are thence able to reduce market prices. If the emergence of such efficient competitors is blocked then the economic system will remain

inefficient and fail to generate both the optimal allocation of productive resources and the maximum possible level of consumer satisfaction. Unfortunately, the real world is beset with myriad obstacles to the emergence of more competitive producers within many industries.

One of the more obvious problems facing a potential producer, and one which illustrates the interrelated character of the basic assumptions of liberal economic theory, is that of information. Successful entry into an industry requires a range of information about technical possibilities, support facilities, outlets and market conditions, both current and future, that is both extensive and extremely difficult, indeed often impossible, to obtain.

The capacity to secure appropriate levels of financial capital is also a serious consideration for the would-be producer in the real world. Here again, the many failings of capital markets may seriously inhibit the prospects of those new entrepreneurs who might, if suitably supported, make a substantial mark upon an industry or even create a new industry. Those who are responsible for determining investments or authorizing loans may lack suitable technical knowledge and understanding, be insufficiently aware of market opportunities, or by unduly averse to exposure to risk.

Intentional barriers to entry may also confront potential producers with overwhelming obstacles. Such barriers may be created by other producers, major purchasers (like large retail chains) or governmental and quasi-governmental authorities. The range of motives for erecting such barriers may range from pure greed through to quite proper concerns for the safety of consumers, the protection of the environment or the maintenance of national security.

Factor Mobility

One special condition of a properly functioning competitive economic system is the full *mobility of factors of production*. If the most suitable equipment, skills or labour force cannot be brought to those places at which some form of production might best be undertaken then inefficiency will result. The cost of production will thus be higher where the introduction of the appropriate factors of production is obstructed: ineffi-

cient procedures will persist and artificially scarce factors of production will receive unduly high financial rewards (or, in the jargon, rents). This applies as much to the movement of human labour as it does to any other factor of production. It is interesting to note, however, that few but the most dedicated of academic liberal economists are prepared to advocate the completely uncontrolled movement of people in the modern world: those governments that profess the greatest dedication to free-market principles almost invariably fall at this particular fence and are often to be found amongst the most vigorous opponents of immigration, particularly of low-cost labour!

Monopoly and Oligopoly

Whatever the sources of the obstacles that confront the would-be entrant into an industry, or the expanding established producer, they have a number of effects. Inefficient producers may be protected, as has been suggested above. In many cases, barriers to entry may serve to protect one or more firms that have secured a dominant place in the market for a given good or service: a monopoly or an oligopoly. Such firms are able to set market prices rather than being forced to accept whatever price the market determines. Common sense, and a wealth of historical evidence, suggests that such positions of market dominance are often abused, with supply and price being manipulated to the considerable advantage of the firm(s) involved. Indeed, in the case of pure monopoly, analysis demonstrates that it is economically rational for the monopolist to sell less of its good or service at a higher price than would obtain in a competitive market.[16] Unfortunately, when monopolists then act rationally they do so at the expense of the maximization of consumer satisfaction and the optimal use of productive resources.

The case of oligopolies is even more problematical for the liberal economic model. The problem here is that oligopolists are faced with a choice between two alternatives. The first choice is to collaborate with the other oligopolists to form a cartel which will act, in effect, like a monopolist, securing higher prices for a lower level of production and sales. This choice is attractive for it offers the oligopolist the combination of a relatively quiet life and higher profits per unit of output than would be obtained in a competitive market. However, the market share of each oligopolist will have to remain more-or-less constant for such a cartel to remain stable. Unfortunately, dissatisfaction with current market share, or concern over some gradual fall in sales, may tempt the oligopolist towards the second option—that of precipitating a competitive struggle.[17] Such struggles between oligopolists will be both uncomfortable and costly but may bring considerable rewards as enhanced market shares are captured.

The problem for liberal economic theory is that it is quite unable to specify whether oligopolists will, in general, cohere or cleave. Worse, whatever their behaviour, it is likely that the long-run effect will be to the consumers' disadvantage for a cartel will maintain higher prices and lower levels of supply while a competitive struggle may eventually result in either a restored cartel or an actual monopoly. It is possible that an oligopoly could sustain perpetual competition, and hence price or quality benefits to consumers, but the historical evidence would suggest that a mixed pattern of successive collaboration and competition is more probable.

The capacity of producers to deploy their resources in such a way as to ensure the maximization of aggregate satisfaction of consumers will also be dependent upon a number of conditions. The earlier discussion of rationality has already implied that the only satisfactions that can be accommodated within the liberal economic model, and hence maximized, are those that can be secured through market exchanges. This is a clear, and major, limitation upon the purview of the model. However, difficulties are also created by the two loosely related issues of income distribution and human homogeneity.

The Distribution of Wealth and Income

One of the conventional, and generally quite valid, defences of a liberal economic system is its capacity to respond to, and satisfy, a wide range of differences of individual want, taste and preference. However, a society will be able to satisfy the existing pattern of human needs and wants maximally only if

all the members of that society have an equal opportunity to express their needs and wants in the market-place. Many ordinary mortals have long suspected that the losses of satisfaction of those who have lower levels of income and wealth, and who are therefore able to purchase less, exceed the extra satisfaction secured from the additional purchases of goods and services by those who are wealthier. A central concept of modern economics—that of marginal utility—comes to the aid of common sense on this potentially sensitive point.

Liberal economic theory holds that, in general, the utility (or benefit) secured from the consumption of any good or service *declines* as more is consumed. The other side of this proposition is that as consumption of any good or service declines the loss of utility (or benefit) will increase progressively. Thus, for the glutton, the benefit secured from an additional potato will be vanishingly small while removing one potato from a pauper will produce an enormous loss of benefit for that unhappy individual. The argument that is here applied to one basic food can equally be applied to the entire range of goods and services that individuals consume and it implies that the lesser satisfactions of the rich are secured at the expense of the considerable losses of satisfaction of the poor.

Many liberals are good defenders of the economic status quo within the richer, *laissez-faire* economies and would not be happy with a notion of marginal utility that condemned substantial inequalities of income and wealth distribution. One defence of such inequalities rests upon what has become known as 'supply-side' economics. Here it is contended that incentives for entrepreneurs are essential for the efforts and investment that are necessary for economic growth and, ultimately, general benefit. If increased inequalities in income and wealth are necessary in the short term, it may well be that income and wealth will become more evenly distributed as the fruits of economic growth are eventually harvested.[18]

A second avenue of escape from the difficulty of inequalities of income and wealth is to introduce the argument that human beings are substantially heterogeneous: that they are

different not only in what they wish to consume but also in the level of satisfaction that they are capable of deriving from various levels and patterns of consumption. This view reduces, essentially, to the proposition that substantial inequalities of purchasing power are acceptable because the marginal benefit actually derived by an extremely wealthy individual from the consumption of, say, a tin of caviar is sufficiently high to at least balance the considerable loss of benefit suffered by the denial to a starving individual of such basic items as a potato or a bread roll.

The assumption of heterogeneous humanity may be convenient for politically conservative liberal economists but it is a departure that generates its own difficulties for the liberal economic model. The problem here is that an economic system that contains people with substantially different wishes may well fail to respond adequately to the entire range of needs and wants. Some needs and wants may be confined to a very few people or may be extremely expensive to satisfy.

Even with a relatively equal distribution of income and wealth, those who have these problematic needs and wants may be unable to mobilize enough effective demand in the market to generate a sufficient level of supply. With a substantially unequal distribution of income and wealth, such goods and services may be those desired by the relatively poor rather than the somewhat more wealthy. If those who want the goods and services in question desire them intensely then it is probable that the system's failure to satisfy them will result in an overall loss of satisfaction, for the alternative goods and services that are actually produced may well provide lower levels of satisfaction to their consumers. Thus, an economic system's satisfaction of one individual's wish for headache tablets is unlikely to offset the loss to another individual who requires an extremely expensive drug in order to control an ailment which is fatal but which is insufficiently common to 'justify' the costs of production.

The central significance of the points that have been made about the unsound basic assumptions of liberal economic theory, and their many implications, is that the criticisms all indicate many of the ways in which a *laissez-faire* system may,

in practice, fail to deliver its promise of a maximization of satisfactions and welfare for all the members of an economic community. However, even were the basic assumptions to prove sound, it would still be necessary for the economic system to be able to generate a pattern of general balance, between demand and supply for all goods and services, for welfare to be maximized. The idea of *general equilibrium* thus assumes a position of central importance within modern liberal economic theory and within that form which has become known as neo-classical economic theory.[19]

The notion of general equilibrium carries, as will be seen, a number of important implications. It is to be seen as something as quite different, qualitatively, from the idea of a multiplicity of states of *partial equilibrium*. This lesser condition is quite unexceptionable. At the heart of the notion of a free market is the idea that price movements will bring supply and demand into balance, however ephemeral, and this is precisely what is implied by the term partial equilibrium. Wherever price mechanisms clear markets and leave no unsatisfied customers then partial equilibirum has been achieved, whether it be in the local vegetable market or on international money exchanges. The implications of this concept are not, however, particularly profound.

The idea of partial equilibrium has a clear connection with that of general equilibrium but in no way implies, or entails, its occurrence. Those who wish to entertain the notion of general equilibrium cannot adduce it from the existence of partial equilibria for it is entirely possible that the existence of the latter will not be accompanied by, or contribute to the development of, the former. If partial equilibria exist in half the markets within an economy, but turbulence characterizes the others, then the equilibria of the former will not, in any way, ensure general equilibrium. The idea of general equilibrium must, therefore, be based upon considerations other than the mere existence, at times, of some instances of partial equilibrium.

The Methodology of Comparative Statics

The idea of general equilibrium in neo-classical economic theory is of particularly interest, for it is both a logical

implication of the functioning of a *laissez-faire* economic system, as envisaged by liberal economic theory, and a necessary assumption of the proposition that such a system will deliver welfare maximization. It is, moreover, the one concept that pinpoints one of the fundamental methodological weaknesses of modern liberal and neo-classical economic theory. The most acceptable (though by no means the only) notion of a condition of general equilibrium is one that can apply only to an economy that is at rest: an economy that is static and unchanging. Indeed, the notion of static conditions is entirely consonant with neo-classical economic analysis in which the basic propositions are illustrated by comparing some prior situation with the more desirable situation that may be achieved once the system, or some component part, has been subject to the beneficent influences of free-market economic processes. This approach is the methodology of *comparative statics*.[20]

Analysis which is conducted upon the basis of comparative statics, whether within economics or elsewhere in the social sciences, has certain characteristics. The sources of change are hypothesized from the theoretical framework of the analysis rather than identified through the study of the real world. The processes of change are largely ignored and are certainly not discovered through empirical investigation. In the case of neo-classical economics the costs of change—adjustment, in the technical language—are ignored, for, as will be seen, the methodology allows them to be assumed away. Finally, time is a non-dimension: it is simply not present in a form of analysis which is necessarily timeless.[21]

The development of this criticism of the concept of general equilibrium and of the methodology of comparative statics is necessarily delicate and difficult for it would be absurd to imply that practising economists are actually silly enough to believe that the world can ever be static. It will, however, be argued that the basic set of ideas with which many liberal economists (and particularly neo-classicists) operate reduce to a model which does require just such an assumption. Moreover, it will be suggested that many propositions about economic policy also rest upon such an heroically unrealistic, but usually latent, assumption.

The point can be illustrated best by considering the possibility that the real economy is in constant and substantial movement, indeed of considerable turbulence. If it is assumed that all changes of productive activity involve some identifiable costs to those involved in production—the scrapping of old equipment, the purchase of new capital, the retraining of personnel, the mental effort involved in developing and marketing new products—then the economy as a whole will be benefited only if the post-adjustment improvements to consumer satisfaction and/or producers' profits and wages exceed those costs. In a world of extreme turbulence and constant change, it is possible that there will be insufficient time during which to market the new products and hence recoup the costs incurred. Adjustment in such circumstances would not be justified and would, indeed, be economically irrational (costs exceeding benefits achieved).

The example considered above is, admittedly, extreme. However, once continuous change is admitted, the relationship between the costs of adjustment in patterns of production and the subsequent benefits becomes an uncertain matter. It can no longer be assumed that the benefits will exceed the costs and, indeed, the outcome may well be unfavourable. There is certainly nothing within neo-classical economic theory that permits the logical deduction that benefits will exceed costs under such conditions, and this is serious for an approach that prides itself upon its deductive logic. Indeed, any assertions that ultimate benefits will, in fact, exceed the costs of adjustment are either pure acts of faith or based upon the examination of particular empirical conditions (rather than theoretical analysis).

Only if the resulting condition is assumed to be static can neo-classical economic theory prove, *deductively*, that the benefits of adjustment must exceed costs. Put very simply, a static condition can be assumed to be unchanging *indefinitely*. If a post-adjustment condition generates any benefit, when compared with the pre-adjustment condition, then *any* level of adjustment costs will be covered *eventually*.

The problem of adjustment in a turbulent environment may be illustrated with a simple example. The targeting of field artillery against a fortress may be compared with the

problems of firing at fast-flying aircraft and even of engaging in an aerial 'dogfight'. When firing a fixed gun against a fixed target it can be assumed that once appropriate adjustments of aim and range have been made that, ammunition remaining plentiful and other conditions remaining constant, successful shots can be made indefinitely and the efforts made in adjusting aim and range rewarded with the eventual destruction of the fortress. In the case of fast-flying aircraft, the ground-based artillery may make any number of adjustments of aim and range without any guarantee of a successful hit, and success in one hit does little to assure success with subsequent shots. Vast quantities of ammunition may thus be used to little practical effect and prodigious adjustment efforts wasted. In the case of an aerial 'dogfight', the fact that both the target and one's own guns are in constant motion gives rise to the possibility that not only will the target succeed in evading even the best-aimed shots but that one's own flying manoeuvres will actually contribute to missing the target.[22]

The appropriate analogies for the world of real economic activity are those of firing at a fast-flying target or even of engaging in an aerial 'dogfight', whereby one's own best efforts may actually contribute to a 'miss'. Unfortunately, neo-classical economic theory is necessarily constrained to the analogy of the fixed gun firing at the fixed target.

It would, however, be erroneous to assume that general equilibrium is always treated as a static condition that actually manifest itself in the real world. Sophisticated liberal economists clearly recognize the dynamism that is inherent in contemporary economic reality and the implications that this has for theory. General equilibrium therefore has to assume a different, more interesting, but yet more problematical form for such theorists. Rather than presuming a static and actual condition, general equilibrium is now seen to be a tendency, underlying reality. The complex and multifaceted developments apparent in everyday reality are held to be drawn towards this underlying tendency by the processes that are endemic to a *laissez-faire* economic system. The condition of general equilibrium is never achieved but, to the extent that it is approximated, the general welfare is enhanced.

The notion of general equilibrium as an underlying tendency within a laissez-faire economic system certainly avoids the difficulties posed by a conception of this condition as static and actual. However, it draws liberal economic theory onto ever more rocky shores, for it commits it to an epistemology from which many liberal theorists would recoil in horror once aware of its implications. The problem here is that the notion of general equilibrium as an underlying trend in economic reality is to treat general equilibrium as a *non-observable*, but central, feature of, or force within, reality. Something has now been given a central place in liberal economic theory which is not directly amenable to the senses but can be adduced only from a theory which is applied to that reality and which can only be identified indirectly through its purported empirical effects. It is, in other words, not an empirical concept and not amenable to simple empirical verification or falsification.

Such a concept of general equilibrium violates a basic tenet of that positivist epistemology and 'scientific' procedure to which some liberal economists lay such claim. Indeed, liberal economics now falls firmly into the 'realist' school of epistemology.[23] Thus, by adopting an underlying tendency view of general equilibrium liberal economics finds itself sharing with Marxist economics one of those features of the latter which liberal economists are so often keen to criticize.

Whatever the epistemological inclinations of liberal economists, it remains clear that *relative stability* has to be assumed in the economic system if claims that the benefits of adjustment will justify the costs are to be made with any confidence. Such claims can, however, be no more than presumptions and, in the increasingly turbulent world economy now experienced, they increasingly assume the appearance of simple blind faith.

Comparative Advantage and Factor Endowments

The dynamic that underlies the supposed tendency towards general equilibrium within the global economy is, as has been indicated, a manifestation of the principle of *Comparative Advantage*. However, this principle also encounters some serious analytical difficulties. In its contemporary form, as

developed by Eli Heckscher and Bertil Ohlin, Comparative Advantage is held to underlie patterns of international economic specialization and trade. Such Comparative Advantage is, in turn, held to rest upon varying patterns of Factor Endowment. Thus, societies are differentially endowed with natural resources, geographical and climatic conditions, capital and skills. They will then tend to specialize in, and export, those goods and services which require greater quantities of those factors of production with which each society is relatively well endowed. Equally, societies will tend to import those goods and services which involve intensive applications of factors of production with which they are poorly endowed.[24]

The need for Heckscher and Ohlin's addition of the notion of Factor Endowments to the principle of Comparative Advantage arose from the tautological character of the original concept. The problem was that Comparative Advantage was supposed to account for observable patterns of specialization and trade, in which societies exported those goods in which they were internationally competitive (for whatever reason) and imported those in which they were internationally uncompetitive. However, the only practical way of establishing the existence of Comparative Advantage was to observe the patterns of competitiveness and trade that actually appeared in practice. Thus it was that explanation was offered in terms of something (Comparative Advantage), the existence of which could be established only by reference to the occurrence of the thing that it was trying to explain (a competitive position internationally). To the question—'What makes a society competitive?'—the principle of Comparative Advantage would have to answer—'The possession of Comparative Advantage'. To the subsequent question—'How do you know that you have a Comparative Advantage?'—the answer would have to be—'When you find that you are competitive internationally'.

The circularity inherent in this outline of Comparative Advantage clearly raises considerable doubts about its analytical and empirical utility. There are two possible avenues of escape from this miasma of tautology. The first is too resort

to the kind of 'realist' epistemology that has been discussed earlier in this chapter. It would be valid, within such an approach, to argue that Comparative Advantage constitutes an underlying, non-observable factor within a *laissez-faire* global economy which exerts an influence upon developments, and is partially, but only partially, reflected in any specific patterns of competitiveness that emerge.

Treating Comparative Advantage as a non-observable within a 'realist' approach to economics is not, however, the way in which the concept is normally treated in liberal economics, nor does it tally with the positivist dispositions of many liberal economists. Developing the principle of Comparative Advantage with the idea of differing Factor Endowments appeared, therefore, to offer the most promising avenue of escape from simple tautology. However, while the Heckscher–Ohlin principle of Factor Endowments clearly enhances the original principle, it does not resolve all the difficulties.

The first difficulty with the principle of Factor Endowments reflects the variety of means through which many goods and services may be produced and brought to the consumer. Quite different mixes of the factors of production may be employed equally effectively in the production of any one good or service: one society may employ considerable quantities of machinery in its farming and relatively little human labour; another, in direct contrast, might employ very little agricultural equipment but large numbers of farm workers. What determines the relative competitiveness of the two societies in international markets for agricultural products then will not be their relative endowments of various factors of production but the costs of those factors individually and the combinations required for agricultural production within the two systems. The equation still reduces, therefore, to the unremarkable proposition that a society will be more competitive in producing and trading any good or service if it can bring it to the market at a lower price than its competitors.

The illusory promise of the doctrine of Comparative Advantage, even when enhanced by the Heckscher–Ohlin principle, is more sharply exposed when questions are posed

about the nature and origins of those suitable endowments of factors of production that generate Comparative Advantage and, hence, the possibilities of international competitiveness. It is clear that there are some relatively immutable endowments, of geography, resource and climate, that furnish some societies with considerable advantages. Possession of certain scare resources equips a society with an *Absolute Advantage*. Possession of particularly fertile land or an appropriate climate provides some societies with advantages in aspects of agricultural production that come close to being absolute. Thus, while pineapples can be grown in Great Britain they can be done so only under such demanding and expensive conditions as to render it no more than common sense to 'surrender' the pineapple-growing business to societies in which their growth barely requires encouragement.

Byond a number of rather obvious, and largely nature-given, conditions the problem for the doctrine of Comparative Advantage is that the overwhelming majority of the pertinent factors of production are man-made. Capital equipment is manufactured and accumulated by human beings. The economic infrastructure is developed and sustained by human beings. Skills, techniques, knowledge and specific competences are developed, acquired and transmitted by human beings. Those attitudes and values that are germane to the process of economic production are also generated, and transmitted from generation to generation, within human societies. Not only are such central elements created by human beings, they are also far from unchanging or unchangeable.

If endowments with factors of production were given for all time, or even for relatively long periods of time, then the analytical framework within which many modern liberal economists work might have something useful to say about the patterns of economic development to which societies would be best advised to direct themselves. However, many societies have demonstrated the extent to which Factor Endowments can be entirely transformed by human effort and, quite frequently, the direction of their governments. The most careful examination of any society's current pattern of Factor Endowment will do little, therefore, than to

establish one or two of the more obvious considerations and limitations, the identification of which has never previously required any study, whatsoever, of economic theory. The concepts of Comparative Advantage cannot transcend this fundamental weakness, however, for it is rooted in a methodology which acts as an intellectual barrier to detailed consideration of the issues of fundamental, and continuous, change and development.

The problems with the doctrines of Comparative Advantage and Factor Endowments can thus be illustrated by the imaginary example of the modern, liberal economist who is transported in time and place to mid-nineteenth-century Japan. What, on the basis of modern trade theory, would our worthy economist recommend, or even expect: a future of even greater specialization in in-shore fishing, rice growing, fan manufacture, wood carvings, formalized art and an interesting sideline in fearsome weaponry?

It is the poverty of much of modern liberal economics, and of neo-classical theory in particular, on the issues of economic growth and development that marks one of its more serious shortcomings. Many of the most cogent critics focus upon this issue, whether the critics be of a Marxist persuasion[25] or advocates, like Professor David Simpson,[26] of the virtues of earlier classical liberal economic theory and analysis.

There are a number of additional conditions which must be satisfied if the liberal order's promise of maximizing aggregate welfare is to be realized. These conditions are: that unfettered economic activity does not generate detrimental, *negative externalities* for self or others; that there are no *paradoxes of rationality* arising from the basic notion of rational economic activity itself; and, finally, that there are no other *zero-sum features* attendant upon economic activity and economic interaction. Unfortunately, there are powerful arguments that seek to establish that *laissez-faire* economic activity does, indeed, generate substantial negative externalities; that serious paradoxes of rationality arise in economic behaviour, with the effect of significantly reducing general welfare; and that zero-sum difficulties are relatively common.

Negative Externalities

It is relatively common for the economic activity of some to generate negative externalities for others. Noise, pollution and general loss of amenity may be imposed upon some by others who are engaged in self-regarding economic behaviour. Such negative externalities may, in principle, be compensated by those who generate them but there is no guarantee that such compensation will be forthcoming unless pressure can be exerted by the victims or by authorities that are prepared to act in their defence. However, where compensation is offered, and is adequate, it will ensure that the benefits of the economic activity that produces negative externalities will be shared fairly between those who have incurred relevant costs.

In the real world there may, however, be many negative externalities which are of such a form as to defy any real restitution. If the environment is irretrievably polluted then no financial settlements between individuals, firms or societies will compensate humanity. Nothing within a purely *laissez-faire* economic system allows such uncompensatable negative externalities to be identified or dealt with. It is possible that the very privatization of purposes and practices, enshrined in liberal economic theory, will encourage a short-term, self-regarding outlook that militates positively against any serious concern with those general losses that are generated.[27] Indeed, as will be argued shortly, a serious paradox of rationality arises on just such issues of economic activity.

Paradoxes of Rationality and Collective Goods

Many situations may generate serious paradoxes of rational action. Rational economic decision making, for instance, requires the possession of comprehensive information. However, the acquisition of information is a costly and time-consuming business. In practice, therefore, it might well be that the costs of acquiring extra information exceed the benefits that such additional information produces for the quality of the decision made. To seek additional information under such circumstances would therefore be economically irrational for costs would exceed benefits. Unfortunately, it may also be unclear, in many real world situations, whether

extra information would, or would not, make a significant contribution to the quality of decision. Such complications and uncertainties are just the stuff of the real world that the basic propositions of liberal economic theory assume away!

Some of the most serious paradoxes of rationality also arise in the realm of *collective goods*.[28] Economic analysis usually distinguishes between two kinds of goods or services: private goods and collective goods. Private goods can be consumed on a purely individual basis. An ice-cream may be purchased individually and consumed individually with no other person allowed to share in its enjoyment. Many private goods can also be produced and supplied on a highly variable basis, to meet the varying levels of demand that develop at various times. The quantities of ice-cream produced may thus be varied relatively easily and speedily.

Collective goods are quite different phenomena to private goods. Their essential characteristics are non-excludability and indivisibility: once such collective goods are produced in, or supplied for, a community it is all but impossible to exclude any member of that community from enjoying the benefits of that collective good or to vary the quantity of benefit obtained by any individual. Denial of benefits to individuals is possible only by their exclusion from the community. The maintenance of a deterrent against aggression by other states provides a collective good for all its citizens and does so on non-excludable and indivisible basis.

Collective goods may be differentiated on a number of other grounds. However, non-excludability and indivisibility are their definitive characteristics. The interesting situation that may then be considered is one in which the provision of such a collective good requires voluntary contributions from the members of a community. The problem that arises here is that it may well be rational for any given member of that community to withhold his, or her, contribution in the hope that the contributions of others will be sufficient to generate the collective good. It is important to note here that the benefit that the individual gains from the provision of the collective good exceeds the value of that individual's contribution to the provision of the collective good. However the opportunity of obtaining a 'free ride' allows the individual to

benefit from the collective good without sharing in the cost of its provision and this is clearly a better cost–benefit outcome than that in which the individual does make a costly contribution.[29]

If 'free riding' was practised by only one member of, or a small group within, a community its effects would be morally regretable but might not, in all probability, prove practically disasterous. There are, however, other features of collective goods, and the impact of 'free riding', that render the matter of great practical consequence. The first, and critical, problem is that liberal economic theory is based upon the assumption that everyone is similarly rational. Thus, if it is rational for one member of an economic community to 'free ride' it is equally rational for all others to 'free ride'. If all attempt to 'free ride' then there will be no contributions and no collective goods (or rides), free or otherwise.

Thus the very principles of economic rationality dictate that individuals who seek to improve their cost–benefit outcomes by 'free riding' on the contributions others make for collective goods end up by denying the benefits of those collective goods to all concerned. Unfortunately, an awareness of the possibilities of 'free riding' will undermine the inclinations to make contributions by those who experience some persisting disposition to contribute. Such 'angels' will be faced with the possibility that there will be insufficient total contributions to generate the desired collective good and that their own contributions will therefore prove fruitless. Worse still, it might be difficult, if not impossible, to recover the futile contributions that have been made. Volunteers who go out at night to mend a failing sea-wall, but who find that they have done so in inadequate numbers, will not be able to recoup their efforts when the sea eventually overwhelms the defences. It is quite irrational, by the tenets of economic rationality, to incur costs without attendant benefits. The risk of such an outcome will, therefore, merely reinforce other temptations to withhold costly contributions to the provision of collective goods, whatever their intrinsic desirability.

Those who are familiar with formal game theory will recognize the parallel between the Prisoner's Dilemma,

'free-riding' calculations and the defensive withholding of contributions. The normal outcome of such conditions will also be familiar; that of generating a mutually disadvantageous outcome in which all are denied a benefit that would have been secured had all acted in an appropriate manner.

The real world provides a mixed picture of success and failure of cooperation. Two keys to successful cooperation are suggested by the analysis of collective action. The first is that special condition in which narrow calculations of self-interest actually do encourage all economically rational actors to make their costly contributions to the provision of collective goods. This situation obtains when each such individual is convinced that his, or her, contribution is marginally decisive: that if the contribution is not made there will be insufficient contributions, overall, to bring the collective good into being but that if the contribution is made there will be just sufficient contributions, with no significant surplus.

The decision that the individual has to make under such conditions is now identical to a choice to purchase a private good: if the contribution is made the collective good is created and a net benefit enjoyed; if the contribution is not made there will be no collective good and a net benefit will have been forgone. There is no opportunity to 'free ride' successfully in this situation. In the absence of an alternative use of the contribution, which would bring higher benefits, it is economically rational for the individual to contribute and thereby secure the benefit of the collective good.[30]

The difficulty with such a solution to the problem of 'free riding' is that every one of those who have to contribute, to bring total contributions up to a suitable level, has to be equally and simultaneously convinced that their contribution is marginally decisive. This is a serious socio-psychological problem to which formal logic has nothing to contribute. Logic indicates that the nature and size of the relevant community has no effect upon the nature of the decisional dilemma. Real world considerations, however, suggest that the nature and size of a group, or community, will be decisive in establishing the pattern of 'inter-subjectivity' that is necessary to secure sufficient contributions.

The second key to the solution of 'free-rider' problems is provided by an examination of those other conditions which might, if present, counteract such mutually damaging tendencies. These counterveiling conditions amount, in effect, to sources of *associated costs and benefits*: associated in that these costs or benefits arise in consequence of making, or withholding, contributions to a collective good but are not the direct benefits, or contributional costs, of that collective good itself. The strengths of these associated costs or benefits may be such as to persuade an individual to contribute to the costs of a collective good that is not actually valued (or not valued as highly as the costs contributed).

The range and sources of the associated costs and benefits that may suppress, and overwhelm, 'free-rider' tendencies is considerable. Individuals may be influenced by their concern to ensure continued membership of a valued social group to contribute to its collective undertakings. A deeply held belief or value system might emphasize the importance of making potentially costly contributions to valuable social goods, such as the patriotism that persuades so many to volunteer in time of war. In some circumstances it is possible for some actors, or agencies, to arrange for contributors to collective goods to receive 'side payments'—other rewards which are conditional upon, but additional to, the primary benefits of the collective good (as with the social and health facilities which many American trade unions offer their members, but which are additional to the unions' primary concern with conditions and pay at work).[31] Finally, contributions may be enforced by some sufficiently compelling agency, as in the case of governments that extract taxes from recalcitrant citizens.[32]

It is the range of sources of associated costs and benefits within domestic society that underlies the frequency with which successful cooperation, and contribution to collective goods, is observed at that level of human activity. At the international level the picture is far less encouraging. Some associated costs and benefits can be mobilized in the areas of limited cooperation between relatively small numbers of states, and other transnational actors, as in the cases of alliances, issue-focused 'clubs' of states, and cartels of commodity producers or distributors.

At the global level it has, unfortunately, been impossible to develop any of the sets of associated costs and benefits discussed above. Effective cooperation on matters of substance have therefore proved extremely difficult, if not impossible, and their fruits somewhat tenuous. The best efforts of many well-intentioned individuals and states, over considerable periods of time, have not succeeded in securing a significant measure of global disarmament, an effective Collective Security system, or a new and more equitable international economic order.

Zeri-Sum Features and Positional Goods

Inhabitants of the real world economy are also faced with situations in which some of their needs and wants can be satisfied only at the expense of the satisfactions of others. Zero-sum features thus arise in a number of areas of economic activity, most clearly in the realms of *positional goods*.[33] The problem with such positional goods is that part, if not the sum of their value to individuals is a direct function of their unavailability to others. Some of the more obvious positional goods—such as positions of status—are excluded from the purview of liberal economic theory by its explicit restriction of focus. They are, however, of considerable significance to some people and are matters which have an important interrelationship with many aspects of economic life.

Other positional goods, and ones which cannot be excluded from the purview of liberal economic theory, are those in which practical conditions mean that the enjoyments of some involve the denial of those enjoyments to others. In crowded communities a premium may attach to properties which have a view that does not include other property. With limited space, however, the clear views of some involve the denial of clear views to others. Indeed, in many areas such a clear view can be secured only at the expense of even more crowded living conditions, and ever more cluttered views, for others. Satisfaction of the demand for positional goods has implications for aggregate value satisfactions similar to the effects of inequalities of wealth and income.

CONCLUSIONS

The purpose of this chapter has been to demonstrate both the major strengths and weaknesses of the liberal approach to economics. An outline of the principal elements of the liberal model of competitive, free-market economic activity, both domestic and international, has, hopefully, suggested something of the appeal of this approach. It should also have indicated how liberal theory illuminates many areas of empirical reality. The criticism of the liberal approach should, however, serve to highlight the many difficulties generated by its core assumptions and basic methodology.

The basic assumptions of the liberal approach to the analysis of economics are serious simplifications of, and unsound assumptions about, important aspects of reality. Its core methodology of comparative statics is also profoundly inadequate, and seriously misleading, as a basis for analysing a dynamic and turbulent global economy. The central concept of rational action also generates paradoxes which undermine the theory's claim to prescribe arrangements that can ensure the maximization of general welfare.

The implication of this critical discussion of the liberal model is that the adoption of an alternative view of economics, and approach to economic policy, can be justified on the basis of the clear shortcomings of the liberal approach itself. It is possible to adopt an approach that is consistent with Economic Realism, or neo-mercantilism broadly defined, as a 'second-best' policy that acknowledges the perversity and mendacity of human agencies which encourages illiberal practices. However, it may equally be that human beings, and their governments, behave in ways that do not accord with liberal tenets, not because they are stupid or perverse, but because the tenets of the liberal position are themselves insecure in the ways that have been suggested in this chapter.

The arguments in the following chapters will not depend upon the argument that the liberal model is inherently flawed. The argument in favour of Economic Realism, or neo-mercantilism, can be founded equally effectively upon a theoretical criticism of the liberal approach or upon a

description of prevailing realities, whatever their origin. However, it has been the purpose of this chapter to suggest that human obduracy in the face of such a compelling doctrine as liberal economic theory may not be entirely the fault of the human beings!

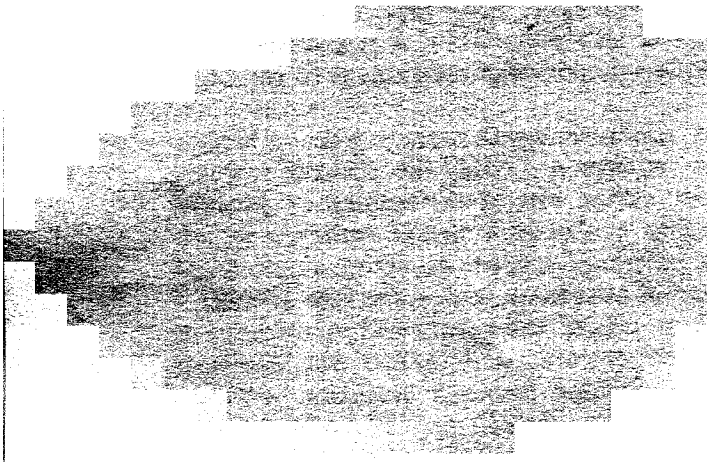
NOTES

1. For a brief summary *see* Andrew Gamble, 'Critical political economy', pp. 64–89 in R. J. Barry Jones (ed.), *Perspectives on Political Economy: Alternatives to the Economics of Depression*, (London: Frances Pinter, 1983).
2. *See* the contributions by R. J. Barry Jones and Richard Little in Barry Buzan and R. J. Barry Jones (eds.), *Change and the Study of International Relations: The Evaded Dimension*, (London: Frances Pinter, 1981).
3. Such changes may be undertaken somewhat less readily than might be supposed, however. *See*: T. S. Kuhn, *The Structure of Scientific Revolutions*, (Chicago: Chicago University Press, 1962); and Leon Festinger, *A Theory of Cognitive Dissonance*, (Evanston, Ill.: Row, Peterson, 1957).
4. *See* John Maclean, 'Marxist epistemology, explanations of "change" and the study of international relations', pp. 46–67 in Buzan and Jones *op. cit.*
5. *See*, for instance, the title of Richard Lipsey's famous introductory text, *An Introduction to Positive Economics*, (London: Weidenfeld and Nicolson, 1963).
6. On the nature and significance of this notion of 'general equilibrium' *see*, in particular, John Hicks, *Causality in Economics*, (Oxford: Basil Blackwell, 1979), Ch. IV; and Phyllis Dean, *The Evolution of Economic Ideas*, (Cambridge: Cambridge University Press, 1978), esp. Ch. 7; and for an interesting discussion of its current status *see* Frank Hahn, 'General equilibirum theory', in D. Bell and I. Kristol (eds.), *The Crisis in Economic Theory*, (New York: Basic Books, 1981), pp. 123–38.
7. For a general discussion *see* C. P. Kindleberger, *International Economics*, (Homewood, Ill.: Irwin, 5th edn., 1973) esp. Chs. 2, 3 and 4: and P. T. Ellsworth, *The International Economy*, (New York: Collier-Macmillan, 1964) esp. Ch. 10.
8. *See*, in particular, Paul A. Samuelson, 'International factor-price equalization once again', *The Economic Journal*, Vol. LIX, No. 234 (June, 1949), pp. 181–97 reprinted in R. E. Caves and H. G. Johnson, *Readings in International Economics*, for the American Economic Association, (London: George Allen and Unwin, 1968), pp. 58–71.

9. T. M. Rybczynski, 'Factor endowment and relative commodity prices', *Economica*, Vol. XXII, no. 84 (November, 1955), pp. 336–41, reprinted in Caves and Johnson, *op. cit.*, pp. 72–7.
10. Harry G. Johnson, 'Factor endowments, international trade and factor prices', *The Manchester School of Economics and Social Studies*, Vol. XXV, No. 3 (September, 1957), pp. 270–83, reprinted in Caves and Johnson, *op. cit.*, pp. 78–89.
11. See, Chris Edwards, *The Fragmented World: Competing Perspectives on Trade, Money and Crisis*, (London: Methuen, 1985), esp. pp. 29–38.
12. *Ibid.*; and *see also* C. P. Kindleberger, *International Economics*, (Homewood, Illinois; Richard Irwin, (5th ed.), 1973), pp. 472–3.
13. *See* Mark H. Willes, '"Rational expectations" as a counterrevolution', in Bell and Kristol, *The Crisis in Economic Theory op. cit.* pp. 81–96; and for a surprisingly sceptical review of 'rational expectations' *see* the brief 'Expecting the future', *The Economist*, 20 October 1984, pp. 19–20.
14. C. P. Kindleberger, *Power and Money: The Politics of International Economics and the Economics of International Politics*, (New York: Basic Books, 1970), p. 19.
15. For a critique of the notion of 'consumer sovereignty', in particular, *see* S. Mohun, 'Consumer sovereignty', pp. 57–75 in F. Green and P. Nore, (eds.), *Economics: An Anti-Text*, (London: Macmillan, 1977).
16. Lipsey *op. cit.* Chs. 18 and 19; and Joan Robinson, '"Imperfect competition" revisited', pp. 166–81, in Joan Robinson, *Contributions to Modern Economics*, (Oxford: Basil Blackwell, 1978).
17. *ibid.*: *see also* P. Kenyon, 'Pricing', pp. 34–45 in A. S. Eichner (ed.), *A Guide to Post-Keynsian Economics*, (London: Macmillan, 1979).
18. For some surveys of 'supply-side' economic doctrines *see* the essays by D. Regan, G. Gilder, E. Meadows, A. Lafer and G. Perry, and I. Kristol, in *Economic Impact*, No. 35 (1981/3), pp. 8–35.
19. Phyllis Deane *op cit.* Ch. 7.
20. Hicks *op. cit.* Ch. IV.
21. Many of these points are suggested by N. Kaldor in 'The irrelevance of equilibrium economics', *Economic Journal*, Vol. 82 (December 1972) pp. 1237–55.
22. Technically speaking, unsuitable, but far from impossible, 'elasticities of supply' would also produce this outcome.
23. *See* Maclean *op. cit.*
24. Kindleberger, *International Economics*, *op. cit.* Ch. 2.
25. *See*, for instance, A. Bose, *Marxian and Post-Marxian Political Economy* (New York: Monthly Review Press, 1957).
26. D. Simpson, *The Political Economy of Growth*, (Oxford: Basil Blackwell, 1983).
27. Fred Hirsch, *Social Limits to Growth*, (London: Routledge and Kegan Paul, 1977), esp. Ch. 5.
28. For a discussion of collective goods *see*: Mancur Olson, *The Logic of*

Collective Action: Public Goods and the Theory of Groups, (Cambridge: Cambridge University Press, 1965); and N. Frohlich and J. A. Oppenheimer, *Modern Political Economy*, (Englewood Cliffs: Prentice-Hall, 1978) esp. Ch. 2.

29. N. Frohlich and J. A. Oppenheimer, 'I get by with a little help from my friends', *World Politics*, Vol. 20 (1970) pp. 104–20.
30. *ibid.*
31. On such factors, *see* Olson *op. cit.*
32. *See* N. Frohlich, J. A. Oppenheimer and O. R. Young, *Political Leadership and Collective Goods*, (Princetown, NJ: Princeton University Press, 1971).
33. Hirsch *op. cit.* Ch. 3.



establish one or two of the more obvious considerations and limitations, the identification of which has never previously required any study, whatsoever, of economic theory. The concepts of Comparative Advantage cannot transcend this fundamental weakness, however, for it is rooted in a methodology which acts as an intellectual barrier to detailed consideration of the issues of fundamental, and continuous, change and development.

The problems with the doctrines of Comparative Advantage and Factor Endowments can thus be illustrated by the imaginary example of the modern, liberal economist who is transported in time and place to mid-nineteenth-century Japan. What, on the basis of modern trade theory, would our worthy economist recommend, or even expect: a future of even greater specialization in in-shore fishing, rice growing, fan manufacture, wood carvings, formalized art and an interesting sideline in fearsome weaponry?

It is the poverty of much of modern liberal economics, and of neo-classical theory in particular, on the issues of economic growth and development that marks one of its more serious shortcomings. Many of the most cogent critics focus upon this issue, whether the critics be of a Marxist persuasion[25] or advocates, like Professor David Simpson,[26] of the virtues of earlier classical liberal economic theory and analysis.

There are a number of additional conditions which must be satisfied if the liberal order's promise of maximizing aggregate welfare is to be realized. These conditions are: that unfettered economic activity does not generate detrimental, *negative externalities* for self or others; that there are no *paradoxes of rationality* arising from the basic notion of rational economic activity itself; and, finally, that there are no other *zero-sum features* attendant upon economic activity and economic interaction. Unfortunately, there are powerful arguments that seek to establish that *laissez-faire* economic activity does, indeed, generate substantial negative externalities; that serious paradoxes of rationality arise in economic behaviour, with the effect of significantly reducing general welfare; and that zero-sum difficulties are relatively common.

Negative Externalities

It is relatively common for the economic activity of some to generate negative externalities for others. Noise, pollution and general loss of amenity may be imposed upon some by others who are engaged in self-regarding economic behaviour. Such negative externalities may, in principle, be compensated by those who generate them but there is no guarantee that such compensation will be forthcoming unless pressure can be exerted by the victims or by authorities that are prepared to act in their defence. However, where compensation is offered, and is adequate, it will ensure that the benefits of the economic activity that produces negative externalities will be shared fairly between those who have incurred relevant costs.

In the real world there may, however, be many negative externalities which are of such a form as to defy any real restitution. If the environment is irretrievably polluted then no financial settlements between individuals, firms or societies will compensate humanity. Nothing within a purely *laissez-faire* economic system allows such uncompensatable negative externalities to be identified or dealt with. It is possible that the very privatization of purposes and practices, enshrined in liberal economic theory, will encourage a short-term, self-regarding outlook that militates positively against any serious concern with those general losses that are generated.[27] Indeed, as will be argued shortly, a serious paradox of rationality arises on just such issues of economic activity.

Paradoxes of Rationality and Collective Goods

Many situations may generate serious paradoxes of rational action. Rational economic decision making, for instance, requires the possession of comprehensive information. However, the acquisition of information is a costly and time-consuming business. In practice, therefore, it might well be that the costs of acquiring extra information exceed the benefits that such additional information produces for the quality of the decision made. To seek additional information under such circumstances would therefore be economically irrational for costs would exceed benefits. Unfortunately, it may also be unclear, in many real world situations, whether

'free-riding' calculations and the defensive withholding of contributions. The normal outcome of such conditions will also be familiar; that of generating a mutually disadvantageous outcome in which all are denied a benefit that would have been secured had all acted in an appropriate manner.

The real world provides a mixed picture of success and failure of cooperation. Two keys to successful cooperation are suggested by the analysis of collective action. The first is that special condition in which narrow calculations of self-interest actually do encourage all economically rational actors to make their costly contributions to the provision of collective goods. This situation obtains when each such individual is convinced that his, or her, contribution is marginally decisive: that if the contribution is not made there will be insufficient contributions, overall, to bring the collective good into being but that if the contribution is made there will be just sufficient contributions, with no significant surplus.

The decision that the individual has to make under such conditions is now identical to a choice to purchase a private good: if the contribution is made the collective good is created and a net benefit enjoyed; if the contribution is not made there will be no collective good and a net benefit will have been forgone. There is no opportunity to 'free ride' successfully in this situation. In the absence of an alternative use of the contribution, which would bring higher benefits, it is economically rational for the individual to contribute and thereby secure the benefit of the collective good.[30]

The difficulty with such a solution to the problem of 'free riding' is that every one of those who have to contribute, to bring total contributions up to a suitable level, has to be equally and simultaneously convinced that their contribution is marginally decisive. This is a serious socio-psychological problem to which formal logic has nothing to contribute. Logic indicates that the nature and size of the relevant community has no effect upon the nature of the decisional dilemma. Real world considerations, however, suggest that the nature and size of a group, or community, will be decisive in establishing the pattern of 'inter-subjectivity' that is necessary to secure sufficient contributions.

The second key to the solution of 'free-rider' problems is provided by an examination of those other conditions which might, if present, counteract such mutually damaging tendencies. These counterveiling conditions amount, in effect, to sources of *associated costs and benefits*: associated in that these costs or benefits arise in consequence of making, or withholding, contributions to a collective good but are not the direct benefits, or contributional costs, of that collective good itself. The strengths of these associated costs or benefits may be such as to persuade an individual to contribute to the costs of a collective good that is not actually valued (or not valued as highly as the costs contributed).

The range and sources of the associated costs and benefits that may suppress, and overwhelm, 'free-rider' tendencies is considerable. Individuals may be influenced by their concern to ensure continued membership of a valued social group to contribute to its collective undertakings. A deeply held belief or value system might emphasize the importance of making potentially costly contributions to valuable social goods, such as the patriotism that persuades so many to volunteer in time of war. In some circumstances it is possible for some actors, or agencies, to arrange for contributors to collective goods to receive 'side payments'—other rewards which are conditional upon, but additional to, the primary benefits of the collective good (as with the social and health facilities which many American trade unions offer their members, but which are additional to the unions' primary concern with conditions and pay at work).[31] Finally, contributions may be enforced by some sufficiently compelling agency, as in the case of governments that extract taxes from recalcitrant citizens.[32]

It is the range of sources of associated costs and benefits within domestic society that underlies the frequency with which successful cooperation, and contribution to collective goods, is observed at that level of human activity. At the international level the picture is far less encouraging. Some associated costs and benefits can be mobilized in the areas of limited cooperation between relatively small numbers of states, and other transnational actors, as in the cases of alliances, issue-focused 'clubs' of states, and cartels of commodity producers or distributors.